

Monthly investment commentary

July 2010

Q2 HIGHLIGHTS

- Global economic growth showed signs of moderating in Q2.
- The Canadian economy remains in expansionary mode; however momentum slowed in the past couple of months.
- Swing in sentiment drove investors to safe haven assets, with the U.S. dollar, government bonds and gold all faring well in the quarter.
- Softer growth pushed commodity prices down, with the CRB Industrials index off 11.3% in Q2. Oil (West Texas) declined 9.4%.
- Long term bond yields dropped, pushing U.S. mortgage rates to their lowest level in almost 40 years.
- Deflationary forces will likely keep U.S. Fed on sidelines for the foreseeable future.
- Corporate earnings growth continues to be strong, although expectations have been pared back.

INCREASING VOLATILITY

No growth or just slowing growth after a rapid recovery? Falling back into a recession, or just a set-back in the recovery? While market strategists have views on each side of the debate, everyday investors turned decidedly more risk averse this spring, causing a sharp pullback in stock markets and a boost to bond markets. (see Table 1)

THE TYPICAL REACTION

This swing toward a more bearish view was driven by concerns about the impact of fiscal belt tightening on economic growth in Europe; policy tightening in China; softer economic statistics out of the U.S.; and, concerns about the potential growth dampening impact of financial regulation on banks and other lenders.

European economic concerns were a significant point of focus during the quarter. In May, a joint European Union – IMF financial package worth 750 billion euros was established to provide confidence and stability in financial markets. The package was put in place to reduce the risk of another credit market crisis, in this case stemming from the sovereign debt concerns surrounding Greece, Spain, Portugal and Ireland. This helped to ease immediate concerns about default; however it translates to a dampened growth outlook for the eurozone for a while to come.

In May, China raised reserve requirements at banks for the third time this year. The move was intended to help prevent the risk of their economy from overheating. Expectations of strong GDP growth and rising real estate prices have raised concerns about higher inflation and potential investor speculation. Then, in the last few days of June, the New York Conference Board revised its leading economic index for China to show the smallest gain in five months in April. This contributed to a significant market sell-off at the end of June as investors cut their growth expectations for China.

With the marked turn in sentiment, investors shifted from risky assets to safe haven assets. Government bonds, the U.S. dollar and gold all showed strength during the quarter.

Table 1– Summary of major market developments

Market returns*	Q2 2010	YTD
S&P/TSX Composite	-6.2%	-3.8%
S&P500	-11.9%	-7.6%
- in C\$	-7.8%	-6.1%
MSCI EAFE	-12.1%	-8.9%
- in C\$	-10.8%	-13.9%
MSCI Emerging Markets	-6.4%	-5.4%
DEX Bond Universe**	2.9%	4.2%
BBB Corporate Index**	2.6%	6.1%

*local currency (unless specified); price only
 **total return, Canadian bonds
 Source: Bloomberg, MSCI Barra, NB Financial, PC Bond, RBC Capital Markets

TIED TO THE GLOBAL GROWTH STORY

Canada's economy has fared well coming out of the recession, with very robust growth in the first quarter of 2010. And, while the Bank of Canada raised its outlook for GDP growth to 3.7 percent for the full year 2010, there have been more recent signs that growth is moderating. A strong housing market and an improving employment picture continue to help the domestic economy expand, however, despite the challenges from a slower U.S. recovery and strength in the Canadian dollar.

The S&P/TSX Composite index, while not immune to the weakness experienced by global stocks generally, managed to outperform the stock markets of most other developed countries in the quarter. Cyclical stocks, which are more tightly tied to global economic growth, were generally hit the hardest. Energy and base metal stocks were hit particularly hard. The overall

decline in the Materials sector was moderated, however, by a 12 percent rise in gold stocks. Gold prices were driven higher in the quarter as investors looked for safe haven assets. (see Table 2)

Table 2 - Sector level results for the Canadian market

S&P/TSX sector returns*	Q2 2010	YTD
S&P/TSX	-6.2%	-3.8%
Energy	-5.6%	-8.2%
Materials	0.6%	0.8%
Industrials	-6.7%	-1.5%
Consumer discretionary	0.9%	6.4%
Consumer staples	-9.5%	-9.7%
Health care	10.6%	21.2%
Financials	-10.6%	-4.3%
Information technology	-25.0%	-20.5%
Telecom services	2.5%	6.9%
Utilities	-6.5%	-4.7%
*price only Source: National Bank		

The Canadian banks, while leaps and bounds healthier than their counterparts in many parts of the world, fell in sympathy with U.S. and European banks, which are expected to experience negative fallout from financial regulatory reforms and European sovereign debt issues.

BOND MARKETS

On June 2nd, Canada became the first country in the G-7 to raise interest rates since the onset of the financial crisis. Canada's strong economic momentum and the need to help keep inflation in check were critical factors in the decision.

With evidence of a slight loss in economic momentum in Canada emerging late in the quarter, deflationary pressures became more dominant, pushing inflationary concerns to the background. This, combined with greater risk aversion by investors, pushed long term bond yields down even lower in the quarter. The DEX Bond Universe index posted a positive 2.9 percent return for the three months ended June 30. It was only three short months ago that investors were worried about imminently rising bond yields and the potential for negative returns. This clearly illustrates how quickly market sentiment can shift and why diversification remains so important.

With bond yields so low, upward pressure on bond yields could re-emerge if investors regain some of their confidence and move back into riskier assets. Market volatility and economic challenges over the short term will likely mitigate some of this risk however. As well, demographically driven investor demand for income-oriented investments also provides some support for bond prices.

SCHOOL'S OUT, BUT DON'T FORGET EVERYTHING!

The recent market pullback reflects a shift in expectations to slower economic growth. This type of market correction, based on a growth scare, was seen at this stage in each of the last two U.S. economic cycles. In each of those cases, the pullbacks proved to be significantly overdone.

The outlook for equities in general remains positive. Company earnings continue on a healthy growth trend and stock valuations appear reasonable – particularly after this latest pullback in stock prices. There is no denying, however, that the risks to capital markets have increased.

And, with another school year in the bag, let's not forget the lessons we've learned from the last year.

1. markets do recover
2. it takes time for sustainable recovery
3. the road to recovery can be bumpy with setbacks
4. diversify and think long term.

Life is full of irony, like when you buy a vuvuzela hoping your soccer team will hear you cheering them on to victory, only to discover that so many others shared the same idea that nobody can actually hear anything but one endless drone. For those of you with a disciplined, long term investment plan, recent market noise should not distract you from your focus – successful long term growth.